United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7258

United States Court of Appeals
FOR THE SECOND CIRCUIT

B

P/S

Docket No. 76-7258

IRVING MASON, on behalf of himself and all others similarly situated, and derivatively on behalf of C. I. REALTY INVESTORS,

Plaintiff-Appellant,

v.

CITY INVESTING COMPANY, C. I. REALTY INVESTORS, C. I. PLANNING CORPORATION, WILLIAM POLK CAREY, JOHN L. GIBBONS, PETER C. R. HUANG, JAMES V. TOMAI, JR., ROBERT M. MORGAN, WILLIAM S. RENCHARD, FRED R. SULLIVAN, JAMES R. WEBB, and REYNOLDS SECURITIES, INC.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANTS-APPELLEES

DAVIS POLK & WARDWELL
Attorneys for Defendants-Appellees
1 Chase Manhattan Plaza
New York, New York 10005
(212) 422-3400

Of Counsel
RICHARD E. NOLAN
MARK L. AUSTRIAN
WILLIAM E. WURTZ

INDEX

PAGE

TABLE OF AUTHORITIES

Cases

PAGE

Statutes and Rules

Other Authorities

United States Court of Appeals

For the Second Circuit

Docket No. 76-7258

Irving Mason, on behalf of himself and all others similarly situated, and derivatively on behalf of C. I. Realty Investors,

Plaintiff-Appellant,

v.

City Investing Company, C. I. Realty Investors, C. I. Planning Corporation, William Polk Carey, John L. Gibbons, Peter C. R. Huang, James V. Tomai, Jr., Robert M. Morgan, William S. Renchard, Fred R. Sullivan, James R. Webb, and Reynolds Securities, Inc.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANTS-APPELLEES

Preliminary Statement

Plaintiff appeals from a decision of the Hon. Inzer B. Wyatt entered on May 3, 1976 dismissing the derivative causes of action in the amended complaint on the ground that plaintiff had failed to satisfy the federal requirement

contained in Fed. R. Civ. P. 23.1 that he consult with C. I. Realty Investors' shareholders before commencing his derivative causes of action.

The District Court correctly followed this Court's decision in *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir.), *cert. denied,* 414 U.S. 1104 (1973), which held that federal courts will look to state law to determine whether a demand on a corporation's stockholders is necessary before a complaint may be filed on behalf of the corporation. Since C. I. Realty Investors was organized under and pursuant to Massachusetts law, the District Court properly looked to Massachusetts law which holds that under the circumstances of this case it is necessary for a stockholder to consult with and make a demand upon his fellow stockholders before filing suit.

By this appeal, appellant seeks to overrule *Brody* in favor of an earlier decision by the First Circuit in *Levitt* v. *Johnson,* 334 F.2d 815 (1964), *cert. denied,* 379 U.S. 961 (1965), which holds that general federal common law, not state law, determines whether a demand on a corporation's stockholders is necessary, and under federal law no demand is necessary where the suit is being brought on behalf of a large corporation. It is appellees' position that this Court's decision in *Brody* is supported by the rationale and judicial history of Fed. R. Civ. P. 23.1. That rule requires a would-be derivative plaintiff to set forth his facts before the owners of the corporation so that they can exercise their sound business judgment and decide in the first instance whether the litigation has sufficient merit to justify the substantial time and legal expense which will be incurred. Far from being in conflict with the Federal Securities Laws, the shareholder demand requirement embodies the principle of informed corporate suffrage that those laws are designed to promote.

Issues Presented

1. Did the District Court err when it concluded that the shareholders of C. I. Realty Investors were entitled to the protection provided by Fed. R. Civ. P. 23.1, and applicable Massachusetts law, which require a derivative plaintiff to consult with his fellow shareholders before requiring the Trust to bring suit in Federal District Court?

2. Did the District Court err when it concluded that it was not obligated to apply the substantive law of the transferor forum (Pennsylvania) for all purposes following a transfer by consent pursuant to 28 U.S.C. § 1404(a)?

Statement of Facts

1. The Parties

Appellee C. I. Realty Investors ("CIRI" or the "Trust") is a real estate investment trust organized under and pursuant to the laws of Massachusetts (40a-60a).* Its shares are listed on the New York Stock Exchange. Appellee C. I. Planning Corporation, an indirectly, wholly-owned subsidiary of Appellee City Investing Company, is CIRI's investment advisor. The individual appellees are past or present members of CIRI's Board of Trustees.

Appellant Irving Mason allegedly purchased 1,000 Units of CIRI, each containing one Share of Beneficial Interest and one Warrant to purchase one Share (4a, par. 1(a)).

2. The Amended Complaint

The original complaint in this action was filed on February 26, 1975 in the United States District Court for the Eastern District of Pennsylvania. The complaint closely paralleled another complaint filed two months before in

---

* Page references are to the Appendix on this appeal.

the same court entitled *David Steinberg et al.* v. *William Polk Cary et al.*, 75 Civ. 1695 (I.B.W.). Both actions named CIRI and certain past and present Trustees of CIRI, C. I. Planning Corporation, City Investing Company and Reynolds Securities, Inc. as defendants and were subsequently transferred on consent to the United States District Court for the Southern District of New York.

On November 19, 1975 appellant served an amended complaint. The amended complaint contains both class action claims and derivative claims on behalf of the Trust. The class action claims, counts I-III and VI, relate to alleged omissions and misrepresentations in the Trust's April 13, 1972 Prospectus and certain additional unspecified documents (4a-27a). Appellant demands an unspecified amount in damages to the class plus attorneys' fees and punitive damages (36a). The factual class action averments in the amended complaint were virtually identical to those contained in the *Steinberg* amended complaint: 28 of the 34 claims of omission and misrepresentation in paragraph 14 of the amended complaint (14a-23a) are carbon copies of the claims in paragraph 14 of the amended *Steinberg* complaint.*

The derivative claims herein, counts IV and V, incorporate by reference the factual averments in the first three class action counts and add general conclusory claims of personal enrichment by the appellees, including the payment of excessive advisory fees, to the detriment of the Trust (27a-34a). Count IV alleges violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 adopted thereunder and Section 14(a) of

---

* A copy of the amended complaint in *Steinberg* was attached as Exhibit A to the affidavit of Ogden N. Lewis, sworn to on December 12, 1975 ("Lewis Aff."), submitted in support of defendants' motion below.

the Securities Exchange Act of 1934, 15 U.S.C. § 78n (1975), and Rule 14a-9 adopted thereunder (27a). Count V is brought pursuant to the court's pendent jurisdiction (33a). Appellant requests an accounting of all direct and indirect benefits received from the Trust on the derivative claims (36a-37a).

3. The Motions Below

On December 12, 1975 defendants moved to stay the class action counts herein on the ground that they were duplicative of those in the *Steinberg* action which were being actively litigated. Defendants also moved to dismiss the derivative counts on the grounds that plaintiff had failed to consult with CIRI's shareholders as required by Fed. R. Civ. P. 23.1 and that plaintiff could not properly maintain a derivative suit on behalf of the Trust at the same time he was prosecuting a class action against the Trust (92a-93a).

4. The District Court's Order

On May 3, 1976 the District Court issued an order staying the class action counts pending a final determination of the *Steinberg* action, and dismissing the derivative causes of action on the ground that appellant had failed to make a demand on the shareholders of CIRI as required by Fed. R. Civ. P. 23.1 and applicable Massachusetts law (93a). The District Court declined to hold that it was obligated to apply the law of the Eastern District of Pennsylvania, the transferor court, on this issue. The District Court also made an express determination that there was no just reason for delay and pursuant to Fed. R. Civ. P. 54(b) entered final judgment in favor of the defendants (93a).

On May 27, 1976 appellant filed a notice of appeal to this Court from the District Court's judgment (94a).

POINT I

Rule 23.1 Requires That, as a Condition to Maintaining This Derivative Action, Appellant Must Comply with Applicable Massachusetts Law Requiring Demand on Shareholders.

A. The Rationale and Judicial History of the Rule

Fed. R. Civ. P. 23.1 provides in pertinent part:

> "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority *and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action and for not making the effort.*" [Emphasis added.]

1. *The Rule Is an Expression of Long Standing Judicial Policy*

The judicial history of this Rule demonstrates a federal policy that shareholders of a corporation are entitled to decide in the first instance when and under what terms their corporation will become involved in litigation. The Rule, recognizing that modern litigation is an extremely time-consuming and expensive proposition, affords these shareholders substantial protection from a plaintiff who, under the guise of being a representative party, would bring a suit purportedly on behalf of the corporation, often in the hope of coercing a quick settlement. Equally important, it expresses the right of a corporation's shareholders in the exercise of their sound business judgment *not* to authorize an action of dubious merit. Conversely, if an action has merit, the Rule gives the shareholders the right to take over the litigation themselves or to direct the corporation to prosecute. By this appeal, appellant would have this protection eliminated.

The federal requirement that a single shareholder of a corporation must consult with all its shareholders before bringing a derivative suit on behalf of the corporation has its genesis in the Supreme Court's decision in *Hawes v. Oakland,* 104 U.S. 450 (1882). There, a shareholder of the Contra Costa Water-works Company sought to maintain a suit on behalf of the corporation against the city of Oakland, California. The Court held that the plaintiff-shareholder was required in the first instance to present its case to all the shareholders of the corporation:

> "But, in addition to the existence of grievances which call for this kind of relief, it is equally important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court. *If time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains.* And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it." 104 U.S. at 460. [Emphasis added.]

The Court explained the reasoning behind this conclusion by quoting from the case of *MacDougall* v. *Gardiner,* 1 Ch.D. 13 (1875):

> "Because there may be a great many wrongs committed in a company,—there may be claims against

> directors, there may be claims against officers, there may be claims against debtors; there may be a variety of things which a company may well be entitled to complain of, but which, *as a matter of good sense*, they do not think it right to make the subject of litigation; and it is the company, as a company, which has to determine whether it will make anything that is a wrong to the company a subject-matter of litigation, or whether it will take steps to prevent the wrong from being done." 104 U.S. at 457. [Emphasis added.]

The Court thus explicitly recognized that there may be situations where the shareholders of a corporation are entitled to decide not to prosecute a claim that could arguably be brought.

Similarly, in *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455 (1903), the Supreme Court affirmed the dismissal of a derivative cause of action under Equity Rule 94* for failure to make a demand upon the directors of the corporation to maintain the action. The Court's language is equally applicable to the requirement that the shareholders must also be consulted:

> "The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interest of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. *The directors may sometimes properly waive*

---

* Following the decision in *Hawes,* in 1882 the Supreme Court adopted Equity Rule 94 containing the requirement of shareholder demand. Equity Rule 94 was superseded by Equity Rule 27 which later became Fed.R.Civ.P. 23(b). *See Goldstein* v. *Groesbeck,* 142 F.2d 422, 425 (2d Cir.), *cert. denied,* 327 U.S. 737 (1944). Rule 23(b) was the forerunner of the present Fed. R. Civ. P. 23.1.

> *a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right.* They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other consideration. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to act which their judgment does not approve, or to substitute his judgment for theirs." 187 U.S. at 463. [Emphasis added.]

Once again the Court supported the right of those who are directly responsible for the corporation's well being to exercise their sound business judgment and decide not to sue.

2. *The Rule Has Been Applied in Connection with the Enforcement of Federally Created Rights*

The right of shareholders to be consulted has also been applied by the Supreme Court in cases where there have been claimed violations of federal laws. In *United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261 (1917), plaintiff brought a stockholders derivative action based on alleged violation of the Sherman Act, 15 U.S.C. § 1, *et seq.* The Court, speaking through Mr. Justice Brandeis, held that the suit could not be maintained absent an application to the corporation's shareholders:

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of

> the stockholders. Courts interfere seldom to control such discretion *inter vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment, and, as a rule, only after application to the stockholders, unless it appears that there was no opportunity for such application, that such application would be futile (as where the wrongdoers control the corporation), or that the delay involved would defeat recovery. In the instant case there is no allegation that the United Copper Company is in the control of the alleged wrongdoers or that its directors stand in any relation to them or that they have been guilty of any misconduct whatsoever. Nor is there even an allegation that their action in refusing to bring such suit is unwise. No application appears to have been made to the stockholders as a body or indeed to any other stockholders individually; nor does it appear that there was no opportunity to make it, and no special facts are shown which render such application unnecessary. For aught that appears, the course pursued by the directors has the approval of all the stockholders except the plaintiffs. *The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation.*" 244 U.S. at 263-264. [Emphasis added.]

In so holding the Supreme Court made it clear that the requirement of shareholder demand was fully consistent with the enforcement of federally created rights. Similarly in *Surowitz* v. *Hilton Hotels Corp.,* 383 U.S. 363, *reh. denied,* 384 U.S. 915 (1966), plaintiff brought a stockholder's derivative action claiming violations of the Securities Act of 1933,

15 U.S.C. § 77a *et seq.*, and the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* The Court applied Rule 23(b) to the question of whether the plaintiff had properly verified the complaint. The Court held that the plaintiff's verification was adequate but went on to say the Rule 23(b) indeed has a place where violations of the Federal Securities Laws are claimed:

> "Rule 23(b) was not written in order to bar derivative suits. Unquestionably it was originally adopted and has served since in part as a means to discourage 'strike suits' by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them." 383 U.S. at 371.

3. *The Courts Have Traditionally Looked to State Law on the Issue of Intracorporate Remedies*

There is little question then that the director and shareholder demand requirements of Rule 23.1 have been consistently applied thoughout the years as a shield against unwarranted derivative litigation. Since the Federal Rules are silent on when and under what circumstances shareholder demand is required, Federal Courts have traditionally looked to state law for the substance of the shareholder demand requirement. This approach recognizes that there are no federal articles of incorporation and that the primary responsibility for the regulation of the internal affairs of state-created corporations resides with the states themselves.

The traditional rule is that the law of the state of incorporation determines the rights of a shareholder to participate in the affairs of the corporation:

> "The local laws of the state of incorporation will be applied to determine the right of a shareholder to

participate in the administration of the affairs of the corporation. . . ." Restatement (Second), Conflict of Laws § 304 (1971).

This rule is based on the principle that all the shareholders of a nationwide corporation are entitled to have their rights and obligations governed by a single body of readily ascertainable law. Since the states have historically taken the primary responsibility for the regulation of corporations, the federal courts have not attempted to create a federal common law governing corporations. *See,* Restatement (Second), Conflict of Laws, § 304, Comment C (1971); Ehrenzweig, *Conflict of Laws,* § 12 at 38 (1962).

It was this guiding principle which caused Mr. Justice Douglas in *Price* v. *Gurney,* 324 U.S. 100, 106 (1945), to look to the law of the state of incorporation to determine whether shareholders of an Ohio corporation could file an action in Federal Court asking relief under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501:

> "The District Court in passing on petitions filed by corporations under Chapter X must of course determine whether they are filed by those who have authority so to act. In absence of federal incorporation, that authority finds its source in local law. If the District Court finds that those who purport to act on behalf of the corporation have not been granted authority by local law to institute the proceedings, it has no alternative but to dismiss the petition. It is not enough that those who seek to speak for the corporation may have the right to obtain that authority."

This principle was reiterated in *Cohen* v. *Beneficial Industrial Loan Corp.,* 337 U.S. 541, 549-550 (1949), which although expressed in the context of a diversity action, none-

theless sets forth the Court's view that state law should govern intracorporate relationships:

> "The very nature of the stockholders' derivative action make it one in the regulation of which the legislature of a state has wide powers. Whatever theory one may hold as to the nature of the corporate entity, it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon state law and may be subject to most complete and penetrating regulation, either by public authority or by some form of stockholder action. . . .
>
> * * * * *
>
> "Likewise a stockholder who brings suit on a cause of action derived from the corporation assumes a position, not technically as a trustee perhaps, but one of a fiduciary character. He sues not, for himself alone, but as a representative of a class comprising all who are similarly situated. The interests of all in the redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity. And while the stockholders have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self-chosen representative and a volunteer champion. The Federal Constitution does not oblige the state to place its litigating and adjudicating processes at the disposal of such a representative, at least without imposing standards of responsibility, liability, and accountability which it considers will protect the interests he elects himself to represent. . . . We conclude that the state has plenary power over this type of litigation."

It was against this judicial background that this Court decided *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir.),

cert. denied, 414 U.S. 1104 (1973), and Judge Wyatt dismissed appellant's derivative causes of action.

B. The District Court Properly Applied This Court's Decision in *Brody* v. *Chemical Bank*

1. *The Court Correctly Applied State Law*

Judge Wyatt relied on his prior decision in *Jones* v. *The Equitable Life Assurance Society of the United States*, 409 F. Supp. 370 (S.D.N.Y. 1975), in reaching his decision that the shareholders of CIRI are entitled to the protection of Fed. R. Civ. P. 23.1 (86a). In *Jones*, plaintiff brought, *inter alia,* a derivative cause of action on behalf of a Massachusetts real estate investment trust claiming violations of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1. The District Court held:

> "In this Circuit the rule is that this Court should look to the state law (here, Massachusetts) 'to determine whether a demand on stockholders is necessary.' *Brody* v. *Chemical Bank,* above cited, at 1114. A decision in the First Circuit, *Levitt* v. *Johnson,* 334 F.2d 815 (1964) *cert. denied,* 379 U.S. 961, 85 S.Ct. 649, 13 L. Ed. 2d 556 (1965), declined to apply Massachusetts law in this respect to an action under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 and following) but this decision was before the *Brody* decision by our Court of Appeals—a decision in a case under the Securities Act of 1933—and my duty is to follow the *Brody* decision." 409 F.Supp. at 374.

In *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir.), *cert. denied,* 414 U.S. 1104 (1973), plaintiff, a preferred shareholder, brought a derivative action on behalf of the Pennsylvania Company ("Pennco") alleging, *inter alia,* that the defendant banks had violated § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), by making a $50,000,000 loan to

Pennco which was subsequently loaned to the then near bankrupt Penn Central Transportation Company. The defendant moved to dismiss the complaint under Rule 23.1 for failure to make a demand upon the directors and shareholders of Pennco. This Court looked to state law to interpret the "if necessary" qualification of Rule 23.1:

> "However, it is settled that the federal courts will look to the state law in such cases to determine whether a demand on stockholders is necessary. Gottesman v. General Motors Corp., 268 F.2d 194, 197 (2d Cir. 1959); Dopp v. American Elec. Labs., Inc., 55 F.R.D. 151, 155 n.10 (S.D.N.Y. 1972)." 482 F.2d at 1114.

Since Delaware law did not require shareholder demand under the circumstances of that case, this Court held that the federal requirement of shareholder demand was satisfied.*

This Court's decision in *Brody* was also followed in *Clairdale Enterprises, Inc.* v. *C. I. Realty Investors,* 75 Civ. 4227 (S.D.N.Y., June 21, 1976), where Judge Duffy also looked to state law to interpret Rule 23.1 and dismissed the derivative cause of action. Finally, this Court's interpretation is consistent with Professor Moore's analysis of the "if necessary" provision in Rule 23.1:

> "The Rule provides that a demand is also to be made upon the shareholders, prior to suit, 'if necessary.' This reservation is inserted since a demand upon the shareholders, unlike the demand upon the directors, is intertwined with the substantive law of corporations dealing with the power of the share-

---

* Appellant's claim that the federal choice of law issue was raised by this Court "on its own motion" (App. Br., p. 20) is wrong. The issue was raised by the appellant in *Brody* as Point I in its main brief. See Plaintiff-Appellant's Brief in *Brody,* pp. 8 to 17.

> holders to ratify 'fraud.' But a negative vote by shareholders not to sue is not a bar to a derivative suit for violations of antitrust law where the vote is an attempted ratification of illegal action rather than an exercise of business judgment. The fact that a demand has been made upon the directors and they have refused to act, does not, however, ipso facto, relieve the plaintiff from seeking corporate redress from the shareholders. But it has been held that where the law of the state of incorporation did not require the pleading of efforts to obtain action from the shareholders, such an allegation would not be required in the federal court. When, however, state law does require an effort as a condition precedent to the maintenance of a derivative action the rule determines the necessity of pleading the effort as well as the particularity of the pleading." 3B Moore, *Federal Practice* ¶ 23.1.19 at 23.1-257-58 (2d ed. 1975)

See also, Price v. *Gurney,* 324 U.S. 100 (1945); *Gottesman* v. *General Motors Corp.,* 268 F.2d 194 (2d Cir. 1959); *Dopp* v. *American Electronic Laboratories, Inc.,* 55 F.R.D. 151 (S.D.N.Y. 1972).

2. *Rule 23.1 and Applicable Massachusetts Law Require That This Suit Be Dismissed*

Section 12.2 of CIRI's First Amended and Restated Declaration of Trust (59a) provides:

> "This Declaration is executed by the Trustees and delivered in the Commonwealth of Massachusetts and with reference to the laws thereof, and the rights of all parties and the validity and construction of every provision hereof shall be subject to and construed according to the laws of said State."

Thus, since CIRI is organized under Massachusetts law, Massachusetts law must be applied to interpret the federal requirement of shareholder demand in Rule 23.1.

Appellant has concededly instituted this action without consulting the shareholders of the Trust (28a). Massachusetts law requires a derivative plaintiff to make such a demand upon shareholders supported by full disclosure of all relevant facts on which its claim is based.* *Clairdale Enterprises, Inc.* v. *C. I. Realty Investors,* 75 Civ. 4227 (S.D.N.Y. June 21, 1976) (applying Massachusetts law); *Jones* v. *The Equitable Life Assurance Society of the United States,* 409 F. Supp. 370 (S.D.N.Y. 1975) (applying Massachusetts law); *Heit* v. *Brown,* 47 F.R.D. 33 (D. Mass. 1967); *Pomerantz* v. *Clark,* 101 F. Supp. 341 (D. Mass. 1951) (applying Massachusetts law); *Datz* v. *Keller,* 347 Mass. 766, 196 N.E.2d 922 (1964); *Braunstein* v. *Devine,* 337 Mass. 408, 149 N.E.2d 628 (1958); *S. Solomont & Sons Trust, Inc.* v. *New England Theatres Operating Corp.,* 326 Mass. 99, 93 N.E.2d 241 (1950); *Almy* v. *Almy, Bigelow & Washburn, Inc.,* 235 Mass. 227, 126 N.E. 419 (1920); *Bartlett* v. *New York, N.H. & H.R. Co.,* 221 Mass. 530, 109 N.E. 452 (1915); *Von Arnim* v. *American Tube Works,* 188 Mass.

* For purposes of the shareholder demand requirement, real estate investment trusts have been treated the same as corporations. *Kaufman* v. *Dreyfus Fund,* 434 F.2d 727 (3d Cir. 1970), *cert. denied,* 401 U.S. 974 (1971); *Jones* v. *The Equitable Life Assurance Society of the United States,* 409 F. Supp. 370 (S.D.N.Y. 1975); *Clairdale Enterprises, Inc.* v. *C. I. Realty Investors,* 75 Civ. 4227 (S.D.N.Y. June 21, 1976); *Pomerantz* v. *Clark,* 101 F. Supp. 341 (D. Mass. 1951); *Greenspun* v. *Lindley,* 44 App. Div. 2d 20, 352 N.Y.S.2d 633 (1st Dep't 1974), *aff'd,* 36 N.Y.2d 473, 479, 369 N.Y.S.2d 123, 127 (1975) ("Appellant cites no case, nor have we found any, in which for present purposes a Massachusetts court has distinguished between a business trust and a business corporation and applied a different rule to the former. Nor do we perceive any legal or practical reason for differentiating here between a business trust and a business corporation.").

515, 74 N.E. 680 (1905); *Dunphy* v. *Travelers' Newspaper Ass'n.*, 146 Mass. 495, 16 N.E. 426 (1888); *Greenspun* v. *Lindley*, 44 A.D. 2d 20, 352 N.Y.S.2d 633 (1st Dep't 1974), *aff'd on other grounds*, 36 N.Y.2d 473, 369 N.Y.S.2d 123 (1975) (applying Massachusetts law); *Wachtel* v. *Baker*, Civ. No. 14772/73 (Sup. Ct., N.Y. Co. 1975) (applying Massachusetts law).

As Judge Wyatt held below, the failure by appellant to make a demand upon the shareholders of CIRI, combined with his failure to allege legally sufficient reasons for not doing so, require the dismissal of the derivative counts of the amended complaint.

a. Purpose of the Rule Is to Allow Shareholders to Exercise Their Sound Business Judgment

The Massachusetts shareholder demand requirement serves two principal purposes. The first is to permit the majority to determine whether it is in the best overall interests of the business that action be taken by anybody, even assuming a claim could conceivably be made. The second is to permit the majority of shareholders to undertake any necessary remedial action themselves. As the court stated in *Pomerantz* v. *Clark*, 101 F. Supp. 341, 344 (D. Mass. 1951):

> "The fundamental basis of the rule is the Massachusetts view that neither an individual member nor a court is usually best fitted to determine whether it is to the interest of a corporation publicly to enforce corporate claims *even if those claims are founded on plainly unlawful conduct participated in by corporate officers or directors.* Solomont's case supra; Brewer's case supra. A disinterested internal organ of the corporation has the advantage of familiarity with the enterprise, with those who have con-

> ducted it and with the record of success or failure. Moreover, it is the internal organs that the member voluntarily chose as his partners in decision when he freely contracted to join their association. Unless it can be shown that each available internal organ is biased, or refused to hear evidence, or acted unreasonably, or in some other manner was disqualified, the courts of Massachusetts will not act at the suit of a minority member. He is remitted to the directors or, if they are disqualified, to the members as a body as the appropriate tribunal to decide not only if a derivative claim has merit but if the corporate welfare is best promoted by suing upon it." [Emphasis added.]

See also, Hausman v. *Buckley,* 299 F.2d 696, 701 (2d Cir.), *cert. denied,* 369 U.S. 885 (1962).

Massachussetts law thus requires that CIRI's shareholders are entitled to exercise their informed business judgment before launching time consuming and expensive litigation allegedly on the Trust's behalf. This policy is the same one stated by the Supreme Court in *Hawes* v. *Oakland,* 104 U.S. 450 (1882), the case which forms the basis for Rule 23.1 (*see* pp. 7-8 *supra*).

Appellant argues, however, that the shareholders of CIRI need not be consulted because this would place an intolerable burden on potential plaintiffs (App. Br., pp. 7, 9, 22, 26, 29, 30) and the shareholders are unable to ratify the purported wrongs (App. Br., pp. 29-32). These arguments fail as a matter of logic and prior court decisions.*

---

* Massachusetts recognizes two limited exceptions to the shareholder demand requirement. Demand may be excused if a derivative plaintiff demonstrates that "immediate action [was] required", or that "there [was] no impartial internal corporate forum to which he [could] resort." *Pomerantz* v. *Clark,* 101 F. Supp. 341, 343 (D. Mass. 1951). Neither of these excuses is alleged in the amended complaint (A. 4a) or pressed on this appeal.

b. Appellant's Claim of Undue Burden Is Without Merit

Implicit in the policy behind Rule 23.1 is the recognition that derivative actions are potentially extremely costly to the corporation both in terms of management's time and attorneys' fees. Since this is a substantial multi-defendant case, if the suit goes forward the Trust can reasonably expect to go through a period of extensive discovery, a long trial and, if necesssary, an appeal. If appellant is unsuccessful in proving his claims, the indemnification provisions in the Trust's Declaration of Trust, § 6.3, provide that the Trust will also be liable for all the attorneys' fees and expenses of the Trustee defendants (49a). The Court can take judicial notice that the cost of this litigation will run into the tens of thousands of dollars which must, of course, ultimately be absorbed by all the shareholders of the Trust.

On the other hand, the financial expense to the appellant of making a demand on the Trust's shareholders is hardly comparable: at present postal rates, it will cost $1,040 to send a mailing to the Trust's approximately 8,000 shareholders not counting whatever minimal expense would be involved in preparing the material. Appellant's claim that there is a significant burden in complying with the proxy rules of the Securities and Exchange Commission is disingenuous (App. Br., p. 29). All that is required by the SEC is that appellant's material be accurate and complete: the amount of work involved in securing this clearance is considerably less than that involved in preparing appellant's brief on this appeal.

Appellant's claim that the Trust's shareholders are unable to make an intelligent decision on what is an unquestionably material issue is equally specious (App. Br., p. 25). The cornerstone of the federal securities laws in general

and the proxy rules in particular is the principle that CIRI's shareholders are entitled and fully equipped, based on proper disclosure, to make intelligent decisions on important matters relating to the Trust's operations and management. Appellant's position carried to its logical conclusion would mean that the annual election of Trustees and the appointment of CIRI's auditors is a meaningless gesture since—in appellant's own words—"it is highly unlikely that these thousands of widely scattered shareholders could ever intelligently discuss" (App. Br., p. 25) the corporation's affairs. Appellant cannot have it both ways: he cannot claim violations of the proxy rules for inadequate disclosure of advisory fee arrangements while at the same time arguing that the Trust's shareholders lack the capacity to make an informed business judgment on this lawsuit.

The real reason appellant is resisting the need to communicate to the Trust's shareholders is the substantial possibility that they will not approve of his conduct in bringing this suit.* Appellant's derivative causes of action incorporate by reference the operative paragraphs of his class action causes of action (27a, 33a). These factual allegations are also being litigated in almost identical form in a class action suit entitled *David Steinberg* v. *William Polk Carey, et al.*, 75 Civ. 1965 (I.B.W.) (*see* pp. 3-5 *supra*).**

---

* Appellant will also have difficulty explaining to CIRI's shareholders how this derivative action can be brought on behalf of the Trust under Rule 10b-5 when there is no allegation that the Trust suffered damages through the purchase or sale of any securities from or to the derivative defendants as required by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, *reh. denied,* 423 U.S. 884 (1975), and this Court in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952).

** Appellant has served detailed interrogatories and requests for voluminous document production incorporating those previously filed in the *Steinberg* action. Lewis Aff., par. 6.

The shareholders could well decide that there is no need for this multiple litigation involving substantial attorneys' fees. If, however, appellant can convince the Trust's shareholders that he has a reasonable chance of succeeding in the case, there is nothing to prevent this litigation from proceeding.

The Massachusetts courts have recognized that the extra cost and effort involved in communicating with the Trust's shareholders are outweighed by the policy of allowing the shareholders to exercise their informed business judgment against frivolous lawsuits. In *Pomerantz* v. *Clark,* 101 F. Supp. 341 (D. Mass. 1951) (applying Massachusetts law), the complaint alleged:

> "(c) Efforts to secure action by John Hancock's policyholders would require a proxy fight with the management. There are several million policyholders of John Hancock who live in all parts of the world and the expense of communicating with them would be prohibitive." 101 F. Supp. at 343.

The court rejected this excuse and stated:

> "The mere fact that the corporation is a large one with scattered members to whom it would be expensive to send proxies and whose support it would be difficult to command even in a just cause has not been recognized in Massachusetts as a ground for not resorting to the body of the members. This is plain from Bartlett's case which involved the New York, New Haven and Hartford Railroad." 101 F. Supp. at 344.

Similarly, in *Jones* v. *The Equitable Life Assurance Society of the United States*, 409 F. Supp. 370 (S.D.N.Y.

1975), the same argument of undue burden was raised and rejected:

> "Admittedly plaintiff made no demand on the shareholders. The reason for not making any such demand is said (para 26) to be that it would have been futile because the trustees decide about the 'bringing of suit,' because if the shareholders authorized the bringing of suit it would then be in hostile hands, and that the Trust has 2,600 shareholders and to engage in demand on them would 'cast an unconscionable financial burden on the plaintiff.' There reasons are not believed to be sufficient." 405 F. Supp. at 374.

And in *Clairdale Enterprises, Inc.* v. *C. I. Realty Investors*, 75 Civ. 4227 (S.D.N.Y. June 21, 1976), involving the same Massachusetts REIT and a claim of violation of the federal securities laws, Judge Duffy stated:

> "The claim that notification of 8000 shareholders as an undue burden would, if accepted, eliminate the notification requirement in any action against a large public corporation. There is no indication that such a result was intended under the federal rules or under Massachusetts law." 75 Civ. 4227 at p. 10.

Finally, in *Bruce & Co.* v. *Bothwell*, 8 F.R.D. 45, 47 (S.D.N.Y. 1948), an undue burden argument was rejected in the case of a corporation having more than 20,000 shareholders scattered around the United States and in several foreign countries:

> "To hold that it is unnecessary to first seek action by the shareholders of a corporation if it has numerous and widely scattered shareholders would deprive such a corporation and the interests of the shareholders of the protection intended by Rule 23(b) and would tend to subject it to unwarranted suits."

Appellant's claim of undue burden has also been rejected in the Fifth Circuit (*Stone* v. *Holly Hill Fruit Products, Inc.,* 56 F.2d 553 (5th Cir. 1932)), the Sixth Circuit (*Haffer* v. *Voit,* 219 F.2d 704 (6th Cir. 1955)) and the Eighth Circuit (*Quirke* v. *St. Louis-San Francisco Railway Co.,* 277 F.2d 705 (8th Cir. 1960)). *See also, Varanelli* v. *Wood,* 9 F.R.D. 61 (S.D.N.Y. 1949); *Greenspun* v. *Lindley,* 44 A.D. 2d 20, 352 N.Y.S. 2d 633 (1st Dep't 1974), *aff'd on other grounds,* 36 N.Y. 2d 473, 369 N.Y.S. 2d 123 (1975); 3B Moore, *Federal Practice* ¶ 23.1.19 at 23.1-258 (2d ed. 1975).

In sum, the burdens imposed by Rule 23.1 are reasonable, serve a well-established purpose and are in complete accord with the policy of the Federal Securities Laws to encourage informed decision-making by CIRI's shareholders.

c. The Ability of CIRI's Shareholders to Ratify the Alleged Wrongs Is Irrelevant under Massachusetts Law

Paragraph 27 of the amended complaint alleges (28a):

> "Furthermore, no demand has been made on the shareholders of the Trust to take any affirmative steps for the reason that the derivative defendants have committed breaches of fiduciary duty involving personal misconduct which are not capable of ratification by a majority of the shareholders or by any other means. Under the circumstances, any demand upon the shareholders of the Trust would be meaningless and, in any event, plaintiff has the right to bring this action."

Massachusetts law, however, recognizes a distinction between the power of CIRI's shareholders to ratify wrongful conduct and their right to prevent a single shareholder from involving the corporation in litigation of dubious merit.

While the ultimate effect is to terminate the litigation, Massachusetts law allows all the shareholders—as opposed to a single shareholder—to exercise their honest business judgment and act as an impartial arbitrator to decide whether the case has sufficient merit to proceed.

In *S. Solomont & Sons Trust, Inc.* v. *New England Theatres Operating Corp.*, 326 Mass. 99, 93 N.E.2d 241 (1950), derivative plaintiffs, as here, alleged, among other things, payment of excessive fees and self-dealing by certain directors. All of the facts supporting the alleged wrongs were separately brought to the attention of both the Board of Directors and the shareholders. A majority of the Board (with the alleged wrongdoers abstaining) and a majority of the shareholders voted not to take action. In upholding dismissal of the complaint, the Court noted that "[m]uch of the plaintiffs' argument is devoted to limitations upon the power of the stockholders to ratify wrongs to a corporation", but refused to rest its "decision upon any power to ratify", stating that the "question whether it is good judgment to sue is quite apart from the question of ratification. This is a distinction of substance and not of form." 326 Mass. at 111-112, 93 N.E.2d at 247. The Court held that a minority of stockholders had no legal right to insist that a suit be brought by a corporation "when in the judgment of the many, in opposition to that of the few, it would be unwise, or even ruinous for the corporation to bring the suit." 326 Mass. at 111-112, 93 N.E.2d at 247. The Court observed that it is "not always best to insist upon all one's rights; and a corporation acting by its directors, or by vote of its members, may properly refuse to bring a suit which one of its stockholders believes should be prosecuted." It emphasized that in such a case "the will of a majority must control." 326 Mass. at 112, 93 N.E.2d at 248. Finally, the Court considered "whether an exception exists requiring a

contrary conclusion where the grounds of suit embrace charges against one or more officers or directors", and stated that it could perceive "no reason" why such an exception should exist. 326 Mass. at 114, 93 N.E.2d at 248-49.

The basic principle of *Solomont* was reaffirmed in *Palley* v. *Baird,* 356 Mass. 737, 254 N.E.2d 894 (1970), where the majority shareholders' refusal to bring suit was upheld, the court holding that there was "no showing" that the majority shareholders acted unreasonably or in bad faith when they decided it "was not in the best interest of the corporation to prosecute the suit by the minority." *See also, Greenspun* v. *Lindley,* 44 A.D. 2d 20, 352 N.Y.S. 2d 633 (1st Dep't 1974), *aff'd on other grounds,* 36 N.Y. 2d 473, 369 N.Y.S. 2d 123 (1975).

The Massachusetts rule and the policy it contains are fully consistent with the Supreme Court's decisions in *Hawes* v. *Oakland,* 104 U.S. 450 (1882), and *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455 (1903), which specifically recognize that shareholders may exercise their sound business judgment and decide not to pursue questionable claims. Similarly, there is nothing in this rule which is inconsistent with the policy of the federal securities law that a corporation's public shareholders are entitled to proper disclosure. If CIRI's shareholders decide that these standards have not been met there is nothing to prevent the vigorous prosecution of this litigation. Thus, under applicable Massachusetts law, ratification is *not* an acceptable excuse.

Nor is it true, as appellant asserts, that "Massachusetts is unique among American jurisdictions" in requiring a demand on shareholders where fraud is alleged (App. Br., p. 20). Many jurisdictions require shareholder demand even when fraud or other wrongdoing not subject to ratifi-

cation is alleged. *Stone* v. *Holly Hill Fruit Prods. Inc.,* 56 F.2d 553 (5th Cir. 1932); *Abraham* v. *Parkins,* 36 F. Supp. 238 (W.D. Pa. 1940); *Bell* v. *Arnold,* 175 Colo. Rpts. 277, 487 P.2d 545 (1971); *American Life Ins. Co.* v. *Powell,* 262 Ala. 560, 80 S.2d 487 (1954); *Escoett* v. *Aldecress Country Club,* 16 N.J. 438, 109 A.2d 277 (1954); *Collins & Glennville R. Co.* v. *Bradley,* 189 Ga. 355, 5 S.E.2d 915 (1939).

Finally, *Gottesman* v. *General Motors Corp.,* 171 F. Supp. 661 (S.D.N.Y. 1959), *appeal dismissed,* 268 F.2d 194 (2d Cir. 1959), cited by appellant in support of his ratification argument (App. Br., pp. 29-30) is unavailing, since this Court looked to New York law which, like Delaware law, permitted ratification as an excuse. The remaining cases cited by appellant (App. Br., p. 30) were either decided with reference to state law other than Massachusetts' or did not apply state law and are thus in direct conflict with this Court's decision in *Brody.*

Appellant's ratification argument also ignores the second policy consideration underlying the Massachusetts law on shareholder demand: to permit the majority of shareholders to undertake any necessary intracorporate action themselves either through persuading the directors to bring the action, bringing the action themselves, or settling the matter with the defendants. See *Halprin* v. *Babbitt,* 303 F.2d 138, 141 (1st Cir. 1962).

In *Rogers* v. *American Can Co.,* 187 F. Supp. 532, 534 (D.N.J. 1960), *aff'd,* 305 F.2d 297, 298, n.2 (3d Cir. 1962), the District Court originally dismissed the action for failure to make a demand upon the shareholders of the corporation pursuant to Rule 23.1. The suit was brought under Sections 4 and 16 of the Clayton Act, 15 U.S.C. §§ 15 and 26. Following this dismissal, plaintiff made an unsuccessful demand upon the corporation's stockholders and reinsti-

tuted the lawsuit. While the Court of Appeals held that the negative shareholder vote would not act as a bar to the later suit,* it cited the District Court's decision that a useful purpose was nonetheless served by requiring shareholder demand in the first instance:

> ". . . There can be many reasons for requiring a stockholder vote. Perhaps the stockholder will be able to effect a satisfactory intracorporate settlement. Perhaps they can persuade the directors to bring the action. Perhaps they will take over the action themselves. Finally, they can, of course, as they did here, reject the idea entirely. Obviously going first to the stockholders has many practical advantages. 187 F. Supp. at 537." 305 F.2d at 317-18.

Thus, even if a negative shareholder vote were not a bar to the institution of this action—and Massachusetts law is specifically to the contrary—shareholder demand would still be required to allow CIRI's shareholders to effect an intracorporate resolution to the problem.

C. Appellant's Remaining Arguments Are Unpersuasive

1. *The General Policies of the Federal Securities Laws Are Not Impeded by Rule 23.1*

Appellant argues that since the federal shareholder demand requirement places some limitation on the right of a single shareholder to bring derivative actions under the federal securities laws it must be ignored. (App. Br. pp. 8-22). The fact is, however, that both Rule 23 and Rule 23.1 were *designed* to place specific limitations on plaintiffs

---

* The Third Circuit did not decide whether state or federal law governed on this point since it interpreted both to mean that a negative shareholder vote was not a bar to a derivative action.

seeking to embroil their corporations in litigation through class and derivative actions. *E.g., Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363, 371, *reh. denied*, 384 U.S. 915 (1966). Congress was presumably well aware of the federal shareholder demand requirements when it passed the Securities Act of 1933 and the Securities Exchange Act of 1934. *Hawes* v. *Oakland*, 104 U.S. 450 (1882), embodying the principle of shareholder demand, was decided almost 50 years prior to the passage of these laws, and the applicability of these requirements to federal enactments was made clear in *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917). No doubt Congress could easily have passed legislation which would have provided that the right of a shareholder to bring a stockholder derivative action under the federal securities laws would not be subject to curtailment by the majority of its shareholders. Since there is no indication that Congress intended to exempt litigation under the federal securities laws from the requirements of Rule 23.1, it would be error to do so now under the guise of judicial construction. *See Davies Warehouse Co.* v. *Bowles, Price Administrator*, 321 U.S. 144 (1943).

Courts have not hesitated to enforce the limitations in Rule 23.1 even when the federal securities laws are involved. The director demand requirement has resulted in the dismissal of many derivative actions. *E.g., Brody* v. *Chemical Bank*, 482 F.2d 1111 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Jones* v. *The Equitable Life Assurance Society of the United States*, 409 F. Supp. 370 (S.D.N.Y. 1975). Rule 23.1 also places additional limitations on the right of a party to commence derivative actions: (1) plaintiff must show that he was a shareholder at the time of the alleged wrong, (2) plaintiff must show that the action was not a collusive one

to confer jurisdiction on the court, (3) plaintiff must fairly and adequately represent the interests of all shareholders and (4) the action cannot be dismissed or compromised without court approval. Should a prospective plaintiff fail to satisfy any of these requirements, the case will be dismissed.

The dangers of unfettered litigation under the federal securities laws also played an important role in the Supreme Court's decision in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, *reh. denied*, 423 U.S. 884 (1975), where the Supreme Court affirmed this Court's "purchaser-seller" requirement and placed a significant limitation on the ability of plaintiffs to sue under Rule 10b-5. The Court recognized that there existed an enormous potential for abuse in 10b-5 actions:

> "We believe that the concern expressed for the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5 is founded in something more substantial than the common complaint of the many defendants who would prefer avoiding lawsuits entirely to either settling them or trying them. These concerns have two largely separate grounds.
>
> The first of these concerns is that in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.
>
> *   *   *   *   *

> The potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure may likewise exist in this type of case to a greater extent than they do in other litigation. The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation. To the extent that this process eventually produces relevant evidence which is useful in determining the merits of the claims asserted by the parties, it bears the imprimatur of those Rules and of the many cases liberally interpreting them. But to the extent that it permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit. Yet to broadly expand the class of plaintiffs who may sue under Rule 10b-5 would appear to encourage the least appealing aspect of the use of the discovery rules." 421 U.S. at 740-741.

There is no policy of the federal securities laws to promote unchecked litigation as appellant claims and Rule 23.1 places important restrictions on the proper enforcement of these laws.

2. **Levitt** ***Is Unsound Judicial Precedent; the Appellant's Attempted Distinction of*** **Brody** ***Is Illogical and Appellant's Remaining Cases Are Inapplicable***

Appellant's principal judicial reliance on this appeal is on *Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965). In *Levitt*, the First Circuit held that federal law governed the issue of whether shareholder de-

mand is necessary and that, where a company has a large number of shareholders, no such demand is required. *Levitt* is inconsistent and irreconcilable with this Court's decision in *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir.), *cert. denied,* 414 U.S. 1104 (1973), as well as with the Supreme Court's decisions in *Hawes* v. *Oakland,* 104 U.S. 450 (1882), *United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261 (1917), and *Price* v. *Gurney,* 324 U.S. 100 (1945), and with the language and judicial history of Rule 23.1.

In *United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 262 (1917), where plaintiff alleged a violation of the Sherman Act, there were 500,000 shares outstanding. Yet under the *Levitt* result no shareholder demand would be required despite the explicit holding by the Supreme Court to the contrary. *Levitt* tries to distinguish *United Copper Securities Co.* by stating that the policy of the antitrust laws is the protection of competing businesses, as businesses, while the Investment Company Act was designed to protect individual investors. 334 F.2d at 820, n. 5. Not only does this attempted distinction involve an unduly narrow statement of the policy behind the Sherman Act, *e.g., Northern Pacific Railway Co.* v. *United States,* 356 U.S. 1, 4 (1958), but it leads to the extraordinary situation that under *Levitt* the requirement of shareholder demand is to be determined on a completely *ad hoc* basis depending on a Federal Court's interpretation of the policy behind a particular federal statute. Finally, its exemption of "large corporations" from the protection of Rule 23.1 has the unsupportable effect of differentiating between "large" and "small" corporations in a manner not authorized by Rule 23.1 or by any of the Supreme Court's decisions on this subject.

The questionable judicial policy of *Levitt* as sound precedent is underscored by the later District Court decision in *In re Kauffman Mutual Fund Actions*, 56 F.R.D. 128 (D. Mass. 1972), *aff'd on other grounds*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). In *Kauffman*, plaintiff brought derivative actions against sixty-five mutual funds and thirty-eight investment advisors managing these funds claiming violation of the federal antitrust laws, the Investment Company Act of 1940, the Securities Exchange Act of 1934 and the Investment Advisors Act of 1934. Two of the Massachusetts fund defendants moved to dismiss the antitrust claims on the ground that plaintiff had failed to make a shareholder demand under Rule 23.1. The District Court granted defendants' motion and rejected plaintiff's argument that shareholder demand was excused because the defendants' shareholders could not ratify the alleged wrongs and the requirement was impossibly burdensome. 56 F.R.D. at 136-140. The court distinguished *Levitt* on the ground that the First Circuit's decision was limited to cases brought under the Investment Company Act. Thus, under *Levitt*, as interpreted in *Kauffman*, a District Court would presumably apply Rule 23.1 as follows: it would (1) require shareholder demand on the federal antitrust count, (2) not require shareholder demand on the Investment Company Act count and (3) attempt an analysis of those claims brought under the Securities Exchange Act and the Investment Advisors Act to see whether shareholder demand is necessary. A more confused and illogical state of affairs can hardly be imagined.

Levitt is unsupported by judicial precedent, unworkable as a matter of judicial construction and inconsistent with the policy of Rule 23.1. *Brody* should not be overruled with *Levitt* installed in its place.

Appellant's attempt to distinguish this Court's decision in *Brody* is illogical (App. Br., pp. 14-15, 20). *Brody* was brought on behalf of the company's *preferred* stockholders who were clearly entitled to maintain a derivative action on behalf of the corporation, *Ashwander* v. *Tennessee Valley Authority*, 297 U.S. 288, 321 (1936), so the fact that all of the corporation's common stock was owned by one shareholder is not a distinguishing factor (App. Br., p. 15) since this Court was obviously not referring to a demand on it. The fact that the applicable state law in *Brody* did not require shareholder demand is also not a distinguishing factor (App. Br., p. 15, n. 7). The important principle established in *Brody* is that state law is controlling on the issue of necessity under Rule 23.1. If *Levitt* were really the rule in this Circuit, this Court could simply have ignored the shareholder demand requirement, as did the First Circuit, instead of looking to Delaware law. This Court's decision to refer to state law to reach this result is further evidence that the *Levitt* rationale was rejected. The same can be said of the court's decisions in *Gottesman* v. *General Motors Corp.*, 268 F.2d 194 (2d Cir. 1959), and *Dopp* v. *American Electronic Laboratories, Inc.*, 55 F.R.D. 151 (S.D.N.Y. 1972), both of which were decided prior to *Brody* and looked to state law instead of fashioning their own rule under federal common law.

Appellant is wrong in claiming that the "overwhelming number of courts which have decided this issue have held that the demand on the stockholders requirement embodied in state law will not control" (App. Br., p. 10) and that "This decision by the Court in *Levitt* has been followed by most of the courts which have considered this issue since 1964" (App. Br., p. 12). The only decision in this Circuit relying on *Levitt* for the proposition that the federal common law governs the interpretation of Rule 23.1 is *Phillips*

v. *Bradford*, 62 F.R.D. 681 (S.D.N.Y. 1974). *Brody* was not discussed in the *Phillips* opinion and a review of the briefs in that case indicates that *Brody* was not cited to the court. *Clairdale Enterprises, Inc.* v. *C. I. Realty Investors*, 75 Civ. 4227 (S.D.N.Y., June 21, 1976); *Jones* v. *The Equitable Life Assurance Society of the United States*, 409 F. Supp. 370 (S.D.N.Y. 1975); and the instant case were each decided after the *Levitt* decision and rejected its holding based on this Court's decision in *Brody*.

Two of the cases cited by appellant in support of his claim that *Levitt* has been followed, *Jannes* v. *Microwave Communications, Inc.*, 57 F.R.D. 18 (N.D. Ill. 1972), and *Weiss* v. *Sunasco, Inc.*, 316 F. Supp. 1197 (E.D. Pa. 1970), were district court opinions outside of the Second Circuit and were decided prior to this Court's decision in *Brody*. Similarly, *Milstein* v. *Werner*, 54 F.R.D. 228 (S.D.N.Y. 1972), and *Kane* v. *Central American Mining & Oil, Inc.*, 235 F. Supp. 559 (S.D.N.Y. 1964), were decided prior to *Brody* and a review of the decisions shows that neither adopted the *Levitt* rationale.

Nor is it accurate to state that decisions of courts of appeals in other jurisdictions are consistent with *Levitt*. In addition to this Court's decision in *Brody*, the Third Circuit in *Rogers* v. *American Can Co.*, 305 F.2d 297 (3d Cir. 1962), approved the District Court's decision dismissing the plaintiff's complaint in the first instance for failing to consult with his shareholders. Appellees are aware of no other court of appeals decision which supports appellant's position here.

Appellant also relies incorrectly on cases in which this Court has held that a plaintiff need not be a registered shareholder at the time of suit, *Drachman* v. *Harvey*, 453 F.2d 722 (2d Cir. 1971), *aff'd in part and rev'd in part on*

other grounds, 453 F.2d 736 (1972) (*en banc*), and that a violation of federal law will not be excused because it is valid under state law, *Marshall* v. *AFW Fabric Corp.*, 533 F.2d 1227 (2d Cir. 1976), *petition for cert. filed*, 44 U.S.L.W. 3720 (U.S. June 8, 1976) (No. 75-1782); *Green* v. *Santa Fe Industries, Inc.*, 533 F.2d 1283 (2d Cir. 1976), *petition for cert. filed*, 44 U.S.L.W. 3720 (U.S. June 6, 1976) (No. 75-1753). The shareholder demand requirement is a *federal* rule designed to protect a corporation's shareholders from "strike suits" and otherwise meritless litigation. It does not prevent litigation but requires that certain procedural steps be taken before a corporation begins a federal proceeding.

Appellant also urges this Court to disregard the state law of shareholder demand on the authority of its decision in *Fielding* v. *Allen*, 181 F.2d 163 (2d Cir.), *cert. denied sub. nom. Ogden Corp.* v. *Fielding*, 340 U.S. 817 (1950), and the Third Circuit's decision in *McClure* v. *Borne Chemical Co.*, 292 F.2d 824 (3rd Cir. 1961), cases involving state security for expense statutes (App. Br., pp. 16-18). This attempt to confuse shareholder demand and security for expenses is invalid as a matter of history and policy and fails to recognize that the *Fielding* and *McClure* decisions rest upon facts unique to security for expense statutes.

The first state security for expenses statute was passed by the New York legislature in 1944, over 10 years after the enactment of the Securities Exchange Act of 1934. Similar statutes thereafter appeared in a few other states, though the majority of states enacted no such legislation. Security for expense laws, aimed at discouraging "strike suits" by small shareholders, were the source of considerable controversy and debate from the time of their enactment. *McClure* v. *Borne Chemical Co., supra,* 292 F.2d 824, 828-29 (3rd Cir. 1961).

In contrast, shareholder demand has formed part of the law of intracorporate relations since the nineteenth century and was part of the *corpus juris* of the states at the time of the adoption of the Securities Exchange Act of 1934.

Such considerations were central to the Court's decision in *McClure,* which accepted the view of Professors Hart and Wechsler that federal law is "interstitial" in character and that it "builds upon legal relationships established by the states." 292 F.2d at 831. The Court then applied this view to the security for expense statutes:

> "One of the most important factors in those cases applying state law to federally-based causes of action has been a presumption that Congress has acted with established state doctrine in mind and has thus intended that state law be 'absorbed' into the federal statute. See, e.g., Davies Warehouse Co. v. Bowles, 1944, 321 U.S. 144, 64 S.Ct. 474, 88 L.Ed. 635. In the instant case, however, the Securities Exchange Act of 1934 was enacted over a decade before the first state security for expenses statute. It cannot be argued successfully therefore, that Congress had these statutes in mind as a background against which it enacted the Exchange Act." 292 F.2d at p. 833.

These facts are far different in the case of shareholder demand, which was recognized as early as 1882 in *Hawes v. Oakland,* 104 U.S. 450, over 50 years before the Securities Exchange Act of 1934 became law.

Moreover, the Court in *McClure* repeatedly emphasizes the controversy surrounding the desirability and efficacy of security for expenses legislation.

> "Unlike statutes of limitations, security statutes do not embody traditional principles of law which are universally accepted. There is sharp dispute as to

> their desirability and efficacy. Moreover, only a minority of our states have enacted such statutes. * * * Congress cannot be presumed to have authorized the courts to engraft a unique and controversial limitation upon a statutory right through its silence on the subject of that limitation." 292 F.2d at 830-831.
>
> * * * * *
>
> "Where a unique and controversial state doctrine alters relationships that are the principal concern of a federal statute that doctrine will not be applied to limit rights arising under the federal statute." 292 F.2d at 835.

The facts are far different in the case of shareholder demand, which is a fundamental and traditional principle of law finding support in numerous other jurisdictions. *Wathen* v. *Jackson Oil & Refining Company*, 235 U.S. 635 (1915); *Rogers* v. *American Can Co.*, 187 F. Supp. 532, 537 (D.N.J. 1960), *aff'd*, 305 F.2d 297 (3rd Cir. 1962); *Quirke* v. *St. Louis-San Francisco Railway Company*, 277 F.2d 705 (8th Cir. 1960); *Haffer* v. *Voit*, 219 F.2d 704 (6th Cir. 1955); *Long* v. *Stites*, 88 F.2d 554 (6th Cir.), *cert. denied*, 301 U.S. 706 (1937); *Stone* v. *Holly Hill Fruit Products Inc.*, 56 F.2d 553 (5th Cir. 1932); *Watts* v. *Vanderbilt*, 45 F.2d 968 (2d Cir. 1930); *Heinz* v. *National Bank of Commerce*, 237 Fed. 942 (8th Cir. 1916); *Macon, D. & S. R. Co.* v. *Shailer*, 141 Fed. 585 (5th Cir. 1905); *Robinson* v. *West Virginia Loan Co.*, 90 Fed. 770 (C.C.D. W. Va. 1898); *Dannemeyer* v. *Coleman*, 11 Fed. 97 (C.C.D. Cal. 1882); *Varanelli* v. *Wood*, 9 F.R.D. 61 (S.D.N.Y. 1949); *Bruce & Co.* v. *Bothwell*, 8 F.R.D. 45 (S.D.N.Y. 1948); *Abraham* v. *Parkins*, 36 F. Supp. 238 (W.D. Pa. 1940); *Caldwell* v. *Eubanks*, 326 Mo. 185, 30 S.W.2d 976 (1930); and *Porter* v. *Mesilla Valley Cotton Products Co.*, 42 N.M. 217, 76 P.2d 937 (1937).

The inescapable conclusion from all the cases and the judicial policy and history of Rule 23.1 is that *Brody* was correctly decided—there is no justification for limiting the scope of Rule 23.1 and denying CIRI's shareholders the protection it affords.

POINT II

This Court Is Not Required to Apply the Law of the Transferor Forum.

Appellant next claims, incorrectly, that the Court below, as the transferee court under 28 U.S.C. § 1404(a), should have applied the law which the transferor forum arguably would have applied and that this would, so he claims, have resulted in a refusal to construe Rule 23.1 as requiring application of Massachusetts law. Under appellant's theory *every* issue in this litigation would be resolved by reference to another federal jurisdiction's laws. There is no rule of law supporting such an approach. If followed, it would produce wholesale forum shopping within the federal system in cases involving antitrust and securities matters in which actions may be brought in virtually any district court in the country.

The whole point of *Van Dusen* v. *Barrack,* 376 U.S. 612 (1964), and the other cases upon which appellant relies, is to preserve the principles established by *Erie RR.* v. *Tompkins,* 304 U.S. 64 (1938), *Klaxon Co.* v. *Stentor Elec. Mfg. Co., Inc.,* 313 U.S. 487 (1941), and *Guaranty Trust Co.* v. *York,* 326 U.S. 99 (1945), that in diversity cases, the federal court should be no more than another court of the forum state, and that the state law of the transferor forum should apply. 376 U.S. at 637-39. The *Van Dusen* case, accordingly, stands only for the proposition that when

convenience would be served by a transfer the plaintiff should not thereby lose the benefit of the substantive state law upon which his case is based. This conclusion is apparent from the quote selected by appellant in his brief on this appeal (App. Br., pp. 32-33):

> "We concluded . . . that in cases such as the present where the defendants seek transfer, the transferee district court would be obligated to apply the *state law* that would have been applied if there had been no change of venue. A change of venue under Section 1404(a) should generally be, *with respect to state law,* but a change of court rooms." 376 U.S. at 639. [Emphasis added.]

These principles do not apply when the issue is an interpretation of *federal* law such as the construction of Rule 23.1. As Judge Lumbard (then Chief Judge) stated in *H. L. Green Co.* v. *MacMahon,* 312 F.2d 650 (2d Cir. 1962), *cert. denied,* 372 U.S. 928 (1963),* which presaged the holding of *Van Dusen* v. *Barrack*:

> "[I]nsofar as the federal courts apply state law, they apply the laws of fifty separate jurisdictions, rather than one . . . . [A] plaintiff may not resist the transfer of his action to another district court on the ground that the transferee court will or may interpret federal law in a manner less favorable to him . . . . *The federal courts comprise a single system applying a single body of law, and no litigant has a right to have the interpretation of one federal court rather than that of another determine his case.*" 312 F.2d at 652. [Emphasis added.]

---

* Appellant is wrong in claiming that the *Green* decision supports his proposition that the federal law of the transferor is to be applied (App. Br., p. 33).

See also, Clayton v. *Warlick*, 232 F.2d 699, 706 (4th Cir. 1956); *Scheinbart* v. *Certain-Teed Products Corp.*, 367 F. Supp. 707, 711 (S.D.N.Y. 1973); *Polaroid Corporation* v. *Casselman*, 213 F. Supp. 379, 383-84 (S.D.N.Y. 1962). It takes little imagination to see that any contrary interpretation would be completely destructive of the principle that federal district courts apply a uniform system of federal laws.

Finally, the danger of forum shopping inherent in appellant's position is adequately illustrated by the case of *Scheinbart* v. *Certain-Teed Products Corp.*, 367 F. Supp. 707 (S.D.N.Y. 1973), where plaintiff unsuccessfully argued against transfer on the ground that she was entitled to certain favorable rulings in the Second Circuit:

> "Plaintiff's argument amounts to mere forum shopping. The federal courts, and this court in particular, have little sympathy for forum shopping. 'The federal courts comprise a single system applying a single body of law, and no litigant has a right to have the interpretation of one federal court rather than that of another determine his case.' Plaintiff's obvious forum shopping merely adds weight to the other considerations favoring transfer." 367 F. Supp. at 711.

This is especially so in the instant case where there existed the possibility of bringing a derivative suit claiming violations of the Federal Securities Laws in numerous different forums. As the *Scheinbart* Court stated:

> "In a derivative action, however, the weight given plaintiff's choice of forum is weakened considerably because the plaintiff is only one of hundreds of potential plaintiffs, 'all equally entitled voluntarily to invest themselves with the corporation's cause of

action and all of whom could with equal show of right go into their many home courts. . . .'" 367 F. Supp. at 711.

Appellant's reference to cases decided in connection with 28 U.S.C. § 1407* does not call for a contrary conclusion (App. Br., pp. 33-36). Section 1407(a) provides:

> "(a) When civil actions involving one or more common questions of fact are pending in different districts, such actions may be transferred to any district for coordinated or consolidated pretrial proceedings. . . . Each action so transferred shall be remanded by the panel at or before the conclusion of such pretrial proceedings to the district from which it was transferred unless it shall have been previously terminated. . . ."

The statute does not contemplate a complete transfer for all purposes but rather presumes that the case will be transferred back to the transferor court after pretrial proceedings have been finished. *See, In re Koratron*, 302 F. Supp. 239 (J.P.M.L. 1969). Accordingly, it obviously makes sense from a policy as well as a practical point of view to apply the law of the district where the case will ultimately be tried where questions of law arise. Similarly, it would make no sense to use the law of the many transferor districts where cases were transferred under § 1404(a) for consolidated trials. It is this principle rather than any general rule that the transferee court is to apply the fed-

---

* *Berry Petroleum Co.* v. *Adams & Peck*, 518 F.2d 402 (2d Cir. 1975); *Stirling* v. *Chemical Bank*, 382 F. Supp. 1146 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975); *In re Four Seasons Securities Laws Litigation*, 370 F. Supp. 219 (W.D. Okla. 1974); *Philadelphia Housing Authority* v. *American Radiator Standard Sanitary Corp.*, 309 F. Supp. 1053 (E.D. Pa. 1969).

eral law of the transferor which explains the result of those decisions under Section 1407.

Accordingly, since the federal law to be applied in the interpretation of Rule 23.1 is the law of the Second Circuit there is no need to speculate what the Third Circuit would hold if it were presented with the issue. However, it should be noted that it is by no means clear that the Third Circuit would dispense with shareholder demand in this case. In *Rogers* v. *American Can Co.*, 305 F.2d 297 (3d Cir. 1962), the Third Circuit approved the District Court's original decision which required that the plaintiff comply with the shareholder demand requirement before bringing suit under the Clayton Act. This is persuasive—if not conclusive—authority that the Third Circuit would also dismiss this case. *See also, Abraham* v. *Parkins*, 36 F. Supp. 238 (W.D. Pa. 1940) (suit dismissed for failure to comply with shareholder demand provisions of Rule 23(b)).

POINT III

Appellant's State Law Claims Must Be Dismissed.

Count V of the amended complaint (33a-34a), alleging purely state law claims, is brought under a theory of pendent jurisdiction. There can be no question that Massachusetts law applies to this claim and that shareholder demand is required. *Hausman* v. *Buckley,* 299 F.2d 696, 701 (2d Cir.), *cert. denied,* 369 U.S. 885 (1962). The mere fact that the plaintiff also alleges a federal cause of action does not excuse him from following the requirements of applicable state law with respect to his state cause of action. *Phelps* v. *Burnham,* 327 F.2d 812 (2d Cir. 1964). The New York choice of law rule applicable to this issue, *Hausman* v. *Buckley*, 299 F.2d 696, 700 (2d Cir. 1962), requires that, since the Trust is organized pursuant to

Massachusetts law, and since its Declaration of Trust, § 12.2, (59a) specifies that Massachusetts law governs, that law must be applied. *Greenspun* v. *Lindley*, 44 A.D. 2d 20, 352 N.Y.S.2d 633 (1st Dep't 1974), *aff'd*, 36 N.Y.2d 473, 369 N.Y.S.2d 123 (1975).

Even if appellant were correct that the law of the transferor district applies here, the result would be the same since the Third Circuit would look to Pennsylvania law on the choice of law rule and Pennsylvania would in turn look to Massachusetts law on the question of shareholder demand. *Murdock* v. *Follansbee Steel Corp.*, 213 F.2d 570 (3d Cir. 1954). Accordingly, since appellant has not satisfied the shareholder demand requirements of Massachusetts law its state law claims must also be dismissed (*see* pp. 17-18, 24-27 *supra*).

CONCLUSION

The judgment of the District Court should be affirmed in all respects.

Dated: New York, New York
September 9, 1976

Respectfully submitted,

Davis Polk & Wardwell
Attorneys for Defendants-Appellees
1 Chase Manhattan Plaza
New York, New York 10005
(212) 422-3400

Of Counsel

Richard E. Nolan
Mark L. Austrian
William E. Wurtz

STATE OF NEW YORK, COUNTY OF NEW YORK ss.: 76-7258

ANDREW J CUSACK being duly sworn, deposes and says that deponent is not a party to this action, is over 18 years of age and resides in the City of NEW YORK, State of NEW YORK. On SEPT. 9, 1976 deponent served 2 COPIES OF BRIEF FOR DEFENDANTS - APPELLEES

upon: RICHARD D. GREENFIELD
111 PRESIDENTIAL BOULEVARD
BALA - CYNWYD, PA. 19004

attorney(s) for party(s) in this action, at the address(es) designated by said attorney(s) for that purpose by:

MAIL [✓] depositing a true copy(s) of the same securely enclosed in post-paid wrappers in a Post Office Box regularly maintained by the United States Postal Service at No. 1 Chase Manhattan Plaza, in the City and County of New York, directed to said attorney(s) at the address(es) set out under his name(~~s~~); that being the address~~(es)~~ ~~within the state~~ designated by him for that purpose in the preceding papers in this action.

LETTER DROP [ ] depositing a true copy of the same, enclosed in a sealed wrapper directed to said attorney(s), in the letter drop or box of, and accessible from without, of said attorney(s) office at the address(es) set out under the name; and that said office was not open at the time of service.

PERSON IN CHARGE [ ] delivering a copy of the same to and leaving the same with the person in charge of said office, said attorney(s) being absent therefrom at the time of said service.

Sworn to before me this 10
day of SEPTEMBER 1976

Herbert W. Brauer

Andrew J Cusack

HERBERT W. BRAUER
Notary Public, State of New York
No. 31-5427285
Qualified in New York County
Commission Expires March 30, 1978

RECEIVED

SEP 9 1976

REMBAR, WOLF & CURTIS

3:50 Helene Best

(2) copies